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REFLECTIONS ON TAX REFORM

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This is a time of trouble for the federal income tax. In accepting his party's nomination for the Presidency, Mr. Carter said:

It's time for a complete overhaul of our income tax system. I still tell you it's a disgrace to the human race. All my life I have heard promises of tax reform, but it never quite happens. With your help, we are finally going to make it happen and you can depend on it.<sup>1</sup>

If the federal income tax has been converted since Mr. Carter's election from "a disgrace to the human race" into one of the glories of Anglo-American jurisprudence, the changes have eluded my scrutiny. More likely, the President, like his predecessors, has discovered that tax reform is more appealing as a political slogan than as an agenda for action. Moreover, he prudently qualified his promise by telling his listeners that he would need "your help." Whether he referred to the delegates in the convention hall or to the nationwide television audience, he clearly has an escape hatch if sued for breach of promise. His performance was subject to a condition precedent that is not likely to be satisfied. Almost everyone wants comprehensive tax reform, but resistance to particular changes almost always outweighs this vague yearning for drastic programs.

But Candidate Carter's harsh words have plenty of support. The newspapers, television and radio give us ample evidence of discontent, occasionally even using the term "taxpayer rebellion." A journalist needing a front page story will never fail if he or she takes a set of facts to a dozen

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1. 32 CONG. Q. ALMANAC 851, 852 (1976).

tax preparation offices, or even revenue agents, and asks for a computation of the hypothetical taxpayer's income tax liability. The answers are never identical, and usually the spectrum range is very broad. To be sure, Congress made several important changes in 1977 to alleviate this problem;<sup>2</sup> and these amendments, costing millions of dollars in revenue, will show up prominently in statistical tables prepared by the IRS to reflect the average number of errors per million tax returns filed. But for the taxpaying individual, these contributions to simplicity are swamped in a sea of residual complications. When the President announced the proposals, some stock market analysts grew bearish on H. & R. Block stock, long regarded as the leading member of a growth industry. They theorized that the demand by taxpayers for assistance in preparing their returns would decline if the rules were simplified; and the stock did drop from \$22.50 to \$20 a share.<sup>3</sup> Within a few months, however, it had risen to \$25.75.

Aside from its complexity, the federal income tax arouses unremitting charges of unfairness. The deductible three-martini lunch that was castigated by President Carter, for example, symbolizes a pervasive feeling that the tax law discriminates unfairly in favor of some taxpayers and against others.

This feeling is fueled—indeed, stimulated—by some of the federal income tax's staunchest supporters.<sup>4</sup> For two decades, for example, tax theorists who are friendly to the federal income tax have pointed out that the effective rate of tax varies widely among taxpayers in the same income bracket, depending on the use they make of tax shelters and other allowances, and that the average effective rate for high income taxpayers is much closer to the average rate paid by low income taxpayers than the statutory rate schedules would lead one to expect. These statistical averages are enlivened and buttressed periodically by Treasury reports on the number of individuals with adjusted gross incomes of \$200,000 or more, whose tax liability is trivial. Although an outside observer might attribute these dramatic reports to a hostile administration seeking to repeal the federal income tax as inherently unfair, they were in fact originally devised by the Treasury in 1968 as part of a tax reform package designed to strengthen the federal income tax.

In the same vein, assertions that the income tax is riddled with special privileges, confers upside-down subsidies on favored groups of taxpayers,

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2. E.g., the increase in the standard deduction and its conversion to the zero bracket amount, for which see I.R.C. § 63(d).

3. N.Y. Times, Feb. 10, 1977, at 58, col. 3. The President announced a proposal to increase the standard deduction on February 2, 1977. See 35 CONG. Q. WEEKLY REP. 209, 210 (1977).

4. For citations and quotations, see Bittker, *Income Tax "Loopholes" and Political Rhetoric*, 71 MICH. L. REV. 1099 (1973), and Bittker, *Effective Tax Rates: Fact or Fancy?* 122 U. PA. L. REV. 780 (1974).

and is a \$77 billion welfare program for the rich—though launched by friends of the income tax in the hope of purging it of these deficiencies—have undoubtedly helped to persuade millions of taxpayers that it is not only unfair, but incurably so. Federal tax reformers have never trained their heavy artillery on either the sales tax or the local property tax, and it is not unusual for ordinary citizens to think that those taxes are more equitable than the federal income tax, though that is hardly the conclusion that tax reformers usually want to promote.

This sense of grievance is especially characteristic of middle-income taxpayers—the same groups who feel that they are excluded from more beneficent federal programs. Having concluded, rightly or wrongly, that they have little power to change matters, they are more likely to lash out at the federal income tax than to join a crusade to reform it. It is not surprising, therefore, that efforts to build up a populist-inspired national constituency for tax reform (*e.g.*, by ex-Senator Fred Harris and Ralph Nader) have not gotten off the ground, and that the McGovern “demo-grant” proposal of 1972, designed as a response to rank-and-file discontent with the federal tax law of the day, got no working class support.<sup>5</sup>

It is hard to assess the political importance of this generalized and unfocused sense of unfairness. The term “taxpayer rebellion” may be only a rhetorical flourish, good for headlines but having no serious political content. Perhaps the same can be said about the increase in litigation by taxpayers who refuse to pay the federal income tax, asserting that it was inspired by the Communist Manifesto, that it is unconstitutional, that federal reserve notes are not legal tender, or that taxpayers are required to keep records in violation of the involuntary servitude clause of the thirteenth amendment.<sup>6</sup> An example of local interest is a claim that the sixteenth amendment was not properly ratified by Ohio, because it did not become a state until 1953, when Congress enacted a statute to settle a dispute about the date of its entry into the union.<sup>7</sup>

Though foredoomed to fail, these lawsuits evidence some ingenuity on the part of taxpayers. The fact that they are exercises in futility, however, does not mean that they should be dismissed out of hand as the bizarre ruminations of cranks. Like the “taxpayer revolt” idea, they manifest a discontent ripe for exploitation by a talented political operator.

Still another reason for reviewing the income tax landscape is provided by the growing movement among tax theorists in favor of an expenditure tax, *i.e.*, a tax based on the amount that the taxpayer spends or consumes, rather than on the amount that he earns.<sup>8</sup> So far, proposals to substitute

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5. 30-2 CONG. Q. WEEKLY REP. 1332, 1333 (1972).

6. For examples, see *United States v. Arlt*, 567 F.2d 1295 (5th Cir. 1978); *Lorre v. Alexander*, 40 A.F.T.R.2d 77-5677 (W.D. Tex. 1977); *McCoy v. Alexander*, 40 A.F.T.R.2d 77-5299 (S.D. Tex. 1977).

7. *Baker v. Commissioner*, 37 T.C.M. (CCH) 307 (1978).

8. See Slitor, *Administrative Aspects of Expenditures Taxation*, in *BROAD-BASED TAXES: NEW OPTIONS AND SOURCES* 227 (R. Musgrave ed. 1973), and sources there

an expenditure tax for the federal income tax or to phase one in gradually, and thus reduce the Treasury's reliance on the income tax, have hardly emerged from the groves of academe. But the expenditure tax concept is finding favor in disparate quarters, and they may succeed in forming a potent coalition in the years ahead.

First, an influential group of economists and business analysts believes that national savings and investment are too low relative to consumption, and that this imbalance is rapidly getting worse because of inflation. Since an expenditure tax would be imposed on consumption but not on the portion of a taxpayer's income that was saved or invested, it would encourage taxpayers to save rather than spend; this would help to reverse the current bias—as these analysts would describe it—in favor of current consumption.

Second, expenditure taxation is an appealing concept to another group: those tax theorists who have always believed that the failure of existing law to exclude savings from taxable income results in a misallocation of resources by altering the taxpayer's pre-tax trade-off between savings and consumption in favor of the latter. I refrain from summarizing their technical argument, partly because I am a lawyer rather than an economist, but the details are no doubt familiar to many of you.

I should point out, however, that these theorists favor an expenditure tax because it will be, in their view, neutral as between savings and consumption. By contrast, the first group is less interested in neutrality than in actively influencing the economic behavior of taxpayers; they favor expenditure taxation as an affirmative instrument of governmental policy, not merely as a device to restore the free play of market forces.

A third group attracted by the idea of taxing expenditures rather than income consists of persons seeking to protect the environment against waste. Although they are not especially enthusiastic about larger capital outlays for industrial plant and equipment, they are even less partial to current consumption.

A final element contributing to this burgeoning interest in expenditure taxation is fear on the part of some tax theorists that the existing income tax law cannot be purged of its complexities and inequities; they see too many political hurdles, each manned by a potent vested interest. To them, federal income tax reform is an impossible dream; as realists, they look elsewhere for a fresh start. Like a newly minted coin, the expenditure tax is free from defects.

I should now like to shift perspective and turn back to the formative years of the federal income tax, primarily to assess the extent to which the academic theorists and political figures who were responsible for the early federal income tax laws foresaw the problems that we must now grapple with.

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cited; TREASURY DEPT., BLUEPRINTS FOR BASIC TAX REFORM 113 (1977); Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

## A. THE FOUNDING FATHERS

Perhaps it is a mistake to unveil the conclusion of my probe into history before setting out any of the details, but I am not a writer of detective stories. My conclusion, in short, is that the founding fathers foresaw almost none of the really troublesome issues that have plagued the federal income tax for the last thirty or forty years. This suggests extreme caution in assessing the merits of any proposed broad-based tax, such as the expenditure tax, until much more thought has been devoted to its long-range ramifications. It may well turn out that its proponents have seriously underestimated its potential for complexity and unfairness and that, however appealing as an ideal, it would if enacted soon be castigated as another "disgrace to the human race."

The tax theorists who shaped the early history of the income tax—when it occupied about the same status as the expenditure tax does today—were preoccupied with only a few issues, most of which concerned the outer limits of the concept of "income." One such issue was whether gifts and bequests should be taxed as income to the recipient. There was no consensus on this issue among theorists. Congress decided in 1913 against including gifts and bequests in the income tax base and there the issue has rested ever since. Occasionally a theorist tries to reopen the question, but I cannot recall any serious effort by tax reformers to alter the 1913 decision on this point.

Another burning issue before World War I was whether the rental value of owner-occupied residences should be includible in income. The legislative decision against inclusion has been consistently criticized by tax economists, but they have not succeeded in drumming up any backing on Capitol Hill. A roundabout way of attacking the issue—repealing or restricting the right of homeowners to deduct interest on their mortgages and local real property taxes—has perhaps fared a little better, but only marginally so.

A third issue that piqued the interest of the early theorists was the proper treatment of fringe benefits furnished by employers to their employees, especially if the normal market value exceeded the amount that the employee would have spent if he or she were free of employer compulsion. An example is the rental value of a residence supplied without charge to a university president, prison warden or public official. Perhaps a three-martini lunch also qualifies as an example, at least if the drinks are consumed by a salesman who would prefer tomato juice, but who thinks it better to be convivial with customers than to be puritanical. The boundary between business and personal benefits and expenditures was not settled in 1913 and remains veiled in obscurity to this day.<sup>9</sup> The founding fathers were bothered by it, but they were no more able to resolve it than those who followed them.

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9. For recent developments, see Overbeck, *Fringe Benefits for Rank and File Employees*, 55 TAXES 820 (1977).

I could expand this summary, but its importance for present purposes lies in the important areas that did not attract attention in the early days of the federal income tax, rather than in the few that surfaced. Before turning to the gaps, however, I should perhaps say that the attention of the early legislators was focused almost exclusively on rates and exemptions; they were rarely concerned with the composition of the tax base, save for the politically explosive issue of interest on state and municipal bonds.

Ever since the nineteen-twenties, a major problem in applying the federal income tax has been the proper treatment of devices used by taxpayers to avoid the full impact of the progressive rate structure. By transferring stocks, bonds and real estate to members of their families, high income taxpayers have tried to shift the responsibility for reporting the dividends, interest and rental income to their children and other low-income relatives, thereby moving income from the donor's top bracket to the donee's lower rate, which in some situations is zero. As is well known, almost every arrangement known to the law—outright transfers, trusts, partnerships, family corporations, foreign entities, etc.—has been employed in this endeavor, and Congress, the IRS and the courts have been equally ingenious in responding to the challenge. The early theorists and legislators were intensely concerned with the ethical, social and political consequences of progressive rate structures, but they almost wholly overlooked the diversity of countermeasures open to taxpayers.

The early history of the income tax was marked by a similar failure to foresee another, closely related problem: the tax status of married couples. The Revenue Act of 1913 taxed individuals, not married couples or families, and this practice continued until 1948, when Congress authorized married couples to file joint returns and thereby qualify for a special "split" rate. But when Congress opted in 1913 for individualism, the founding fathers seem to have disregarded the community property system that prevailed in eight western and Pacific Coast states, where marriage was viewed as a financial partnership, as well as an emotional one. Under local law, each spouse's income, whether derived from wages, self-employment, or investments, was owned 50-50 by husband and wife; community property residents, naturally, immediately contended that they were entitled to file tax returns accordingly.

It is extraordinary that this issue was not settled until 1930, when the Supreme Court in *Poe v. Seaborn* upheld the right of community property couples to divide their joint income for federal income tax purposes.<sup>10</sup> The result of this decision was that community property couples were automatically protected against the full force of the progressive rate structure; by contrast, their counterparts in common law states could do very little

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10. *Poe v. Seaborn*, 282 U.S. 101 (1930). See generally Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389 (1975).

to divide their earned income, and their ability to split investment income for tax purposes was subject to many uncertainties, unless the richer spouse made an absolute gift, with no strings attached, to the other spouse.

These disparities prevailed until 1948, when Congress authorized married couples to file joint returns and to pay the same amount of tax as would be paid by a community couple who reported their income equally on two separate returns. The effect of the so-called income-splitting joint return is that married couples with the same amount of income pay the same tax whether they live in a community property or common law jurisdiction, and without regard to the proportion in which they contribute to the aggregate amount of income.

None of the problems leading up to the 1948 joint return were foreshadowed by the debates of the early tax theorists. *A fortiori*, they did not foresee the residual problems that still plague us in this area, such as the so-called "marriage tax" paid by some two-job married couples because their joint liability is greater than the liability they would incur if unmarried, or its counterpart, the "singles tax," so-called because many unmarried taxpayers would pay less if they were married.

Another central problem in federal income taxation that was almost wholly ignored in the early debates concerns the time when income is to be reported. This issue can be subdivided into two components. First, taxpayers do not take unrealized appreciation and depreciation into account annually, but wait until the gain or loss is realized by sale, abandonment or other event. By deferring the recognition of gains and losses until they are realized, the tax law avoids the need for annual appraisals of the taxpayer's assets, and it protects taxpayers against having to pay taxes on gains ("paper profits") that have not yet been turned into cash. But these advantages have an offsetting administrative cost: taxpayers can often postpone or accelerate transactions in order to fit them into taxable years when they will produce the greatest tax benefit. Recognizing this, Congress has in turn imposed numerous complicated restrictions on artificial and manipulative devices designed to undercut the progressive rate structure.

The second component of the timing issue is that most taxpayers are permitted to use the cash receipts and disbursements method of accounting for income, instead of the more accurate accrual method. This privilege eliminates a great deal of bookkeeping for millions of taxpayers, many of whom do not even know that there is an alternative way to compute income, but it also plays an important role in most tax shelters and other manipulative arrangements to escape the full force of the progressive rate structure. A familiar example is the deferral by prize-fighters, actors, authors and other superstars of portions of their earned income until retirement, when the taxpayer anticipates that other income will decline so that the deferred amounts can be collected and reported with less pain than if the income had been received and reported when the services were performed.<sup>11</sup>

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11. See note 9 *supra*.

Still another feature of federal income taxation that escaped serious attention in its formative years is the impact of treating corporations as separate taxable entities. I must qualify this statement by acknowledging that the Revenue Act of 1913 did tax the shareholders of a corporation on its undistributed income if it was "formed or fraudulently availed of" to protect its shareholders against the personal surtax by accumulating its earnings instead of distributing them.<sup>12</sup> This provision was soon converted into a penalty tax on the corporation itself (the predecessor of current I.R.C. section 531), but even in its original form it addressed only one aspect of the separate relationship between corporations and their shareholders, leaving a host of other troublesome issues to be worked out gradually in later years.

Since the separate corporate income tax was enacted in 1909, four years before the sixteenth amendment was ratified, perhaps the corporate tax was simply carried forward in 1913 as an independent feature of the tax landscape, with little regard to its relationship to the newly enacted personal income tax. At any rate, the founding fathers either failed to think about the impact of corporate distributions, liquidations, reorganizations and other corporate transactions on the tax liability of individual shareholders, or they deliberately passed the buck to future legislators.

Another unforeseen development was the distinction between capital gains and ordinary income, which is often viewed with some accuracy as the most important single source of complexity in today's federal income tax laws. Indeed, the 1913 legislators had so rudimentary a level of familiarity with the concept of income that they were puzzled about how to determine gain on a simple sale of property, and this precluded any attempt to grapple with more complicated notions, such as capital gains and losses. As evidence, I cannot resist quoting part of an extended argument in the Senate about the computation of profit on the sale of a horse:

Mr. Cummins. . . . [S]uppose 10 years ago I bought a horse for \$900, and this year I had sold him for \$1,000, what would I do in the way of making a [tax] return?

. . . .

Mr. Williams (a member of the Senate Finance Committee). . . . That thousand dollars is a part of the Senator's receipts for this year, and being a part of his receipts, that much will go in as part of his receipts, and from it would be deducted his disbursements and his exemptions and various other things.

Mr. Cummins. Would the price I paid for the horse originally be deducted?

Mr. Williams. No, because it was not a part of the transactions in that year; but if the Senator turned around and bought another horse that year, it would be deducted.

. . . .

Mr. Bristow. Mr. President, I desire to ask a question, and see if I have this matter clear in my mind. As I understood the question of the Senator

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12. Tariff Act of 1913, ch. 16, § II, 38 Stat. 166.



from Iowa, it was, if he bought a horse 10 years ago for \$100—

Mr. Cummins. Nine hundred dollars.

Mr. Bristow. And sold it this year for a thousand dollars, whether or not that thousand dollars would be counted as a part of his income for this year, regardless of what he paid for the horse 10 years ago. Is that correct?

Mr. Williams. No; I did not say that. It would be a part of his gross receipts for the year, of course, but it may not necessarily be a part of his net receipts, and therefore not a part of his income that is taxable.

Mr. Cummins. But I asked the Senator from Mississippi specifically whether, in the case I put, the price that was originally paid for the horse could be deducted from the price received.

Mr. Williams. The price paid 10 years ago? No; of course not. How could it? When a man puts in his return for his income of the previous year in order to be taxed he puts down everything he has received and everything he has paid out, subject to the exemption and limitations otherwise provided in the bill. Necessarily that is so: To answer the Senator, I want to read the precise language of the provision.<sup>13</sup>

Needless to say, the provision that the Senator then read was too abstract to be helpful—it provided that “the net income of a taxable person shall include gains, profits, and income” from a variety of sources, including “sales or dealings in property,” without explaining how the amount of gain was to be determined. In any event, a deliberative assembly that was preoccupied by the sale of a \$1,000 horse could hardly be expected to devote much attention to the more arcane aspects of the term “income,” including the distinction between capital gains and ordinary income.

Finally, the founding fathers were thoroughly imbued with the view that taxes should be levied for revenue only, a principle that was then almost universally accepted. As a result, they failed to foresee that Congress would come to use the federal income tax law as a major instrument of economic and social policy. Though deplored by some influential commentators, the practice of using the Internal Revenue Code to encourage building construction, business investment, research expenditures and many other activities is deeply entrenched and is not likely, in my opinion, to be reversed in the foreseeable future. Whether this prediction is correct or not, my purpose today is simply to record the fact that this astonishing growth in the use of tax allowances as incentives was not anticipated when the federal income tax was in its infancy.

## B. WHERE WE ARE TODAY

In this section I want to concentrate on several aspects of today's tax law. I will argue that, whether it is a national disgrace or not, it is far more rational than its critics often allege, that its complexities are difficult to eradicate because they usually rest on plausible and persuasive grounds and that attributing their tenacity primarily to narrowly selfish interests

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13. 50 CONG. REC. 3775-76 (1913).

underestimates their staying power by disregarding an important source of their strength.

In particular, I will focus on two subjects: the relationship of complexity to tax reform and the difficulty of measuring the impact of exclusions, deductions, credits and other special tax allowances.

At the end of President Carter's first year in office, the Treasury Department released a pamphlet entitled "Blueprints for Basic Tax Reform," with a foreword in which Secretary Simon said: "It is time to start over from scratch and develop a new tax system in the United States. It must be a system that is . . . based on a clear and consistent set of principles, which everyone in the United States can understand."<sup>14</sup> In this vein, the Treasury offered the public a choice between "two specific model tax systems." One is based on income like the existing federal income tax, but with a much broader base, integration of the personal and corporate taxes, full taxation of capital gains, an adjustment for inflation, and other important reforms. The other model is an expenditures tax, based on the dollar amount of goods and services purchased and consumed by the taxpayer. Responding to the President's assertion that the existing tax law is a "disgrace," the Treasury naturally wished to transform the Internal Revenue Code into a thing of beauty, worthy of a place of honor in the Statutes at Large.

Both of the Treasury's new models attracted a good deal of interest and praise in academic circles, but so far as Capitol Hill was concerned, they were DOA—dead on arrival. Some of you may have seen a recent cartoon in the *New Yorker*, in which a patron of a neighborhood bar says to his drinking companion: "For thirty years I never thought about the Panama Canal, and now I find that I can't live without it." In the same vein, many Congressmen and their constituents might have said: "For thirty years I have denounced the complexities of the Internal Revenue Code, and now I find that I can't live without them."

When tax reforms fail, journalists and academicians customarily put the blame on "special interests"—groups determined to enact, preserve or expand their own tax privileges, without regard to the common interest. Senator Long's favorite way of making this point is a bit of doggerel:

Don't tax you,  
Don't tax me;  
Tax that fellow  
Behind the tree.

I would be the first to agree that political power, exercised in support of economic interests, is an important part of the story, although I would add that some of the special interests seeking to preserve particular provisions encompass hundreds of thousands of taxpayers, who have considerable

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14. TREASURY DEPT., BLUEPRINTS FOR BASIC TAX REFORM (foreword) (1977).

political clout even though very few of them are named John D. Rockefeller or Henry Ford. But political influence and entrenched economic interests are only part of the story, and perhaps not even the most important part.

In the course of writing what will become, if I survive, a multivolume treatise on federal taxation, I have had a close encounter with almost every substantive provision of the Internal Revenue Code. I wish to report, however damaging this iconoclastic conclusion may be to my reputation, that they make far more sense than one is led to expect by most popular and some expert opinions on the subject. To be brief—at the risk of being misunderstood—what comes across to me is a surprisingly high level of rationality, judicious compromise, and concern with important social values. To be sure, these favorable attributes are often buried in turgid prose, qualified by excessive detail, and accompanied by indefensible provisions. Taking the Code as a whole, however, it may well be preferable to a tax law that will “wipe the slate clean of personal tax preferences, special deductions and credits, exclusions from income and the like,” as Secretary Simon recommended in his foreword to *Blueprints*. Indeed, when push came to shove, the Treasury itself “considered practical realities” and preserved in its model income tax law a good many “special deductions” and other tax allowances—though not nearly enough to placate Congress. It is difficult to wipe the slate clean, in my view, because this would require the repeal of too many provisions that ordinary citizens, even when they have no direct financial stake in their perpetuation, regard as fair and sensible. I would like to illustrate this heterodox claim by examining the credit allowed by existing law for expenses incurred by working parents for the care of their minor children, an allowance whose statutory predecessor was enacted in 1954 over the opposition of many tax reformers.<sup>15</sup>

First, a few words about the pre-1954 law, which still controls the tax treatment of expenditures that do not meet the standards of the statutory credit or that exceed its dollar limits. In the leading case on the subject, the Tax Court, which was upheld on appeal by the Court of Appeals for the Second Circuit, held that a two-job married couple could not deduct, as a business expense under section 162 of the Internal Revenue Code, the cost of nursemaids employed to care for their young child during working hours.<sup>16</sup> The court said that the couple’s child care expenses bore only an “indirect and tenuous” relationship to their employment, and it expressed fear that allowing a deduction would take the IRS and the courts down a slippery slope, ending in tax deductions for the employed taxpayer’s food, clothing and shelter.

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15. I.R.C. § 44A (1954), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 504(a)(1), 90 Stat. 1563.

16. *Smith v. Commissioner*, 40 B.T.A. 1038 (1939), *aff’d without opinion*, 113 F.2d 114 (2d Cir. 1940).

The analogy was not entirely persuasive. Food, clothing and shelter are necessary whether one is employed or not. By contrast, the child care expenses incurred by the taxpayers before the court were necessary only because they were both employed, and they would evidently not have been incurred if one or both of them had been able to stay at home. On the other hand, the child care expenses resulted from the couple's earlier personal decision to have children (and to keep them rather than put them up for adoption); thus, they differed from such ordinary and necessary business expenses as the cost of occupational uniforms, tools of the trade and union dues, and this is why so many tax theorists objected to the allowance.

Whether the court was right or wrong in refusing to allow child care expenses to be deducted, its decision obviously discouraged married couples with small children from seeking dual employment. Assume, for example, that one spouse is already employed at \$15,000 per year and that the other spouse has an opportunity to earn the same amount, but only if they are willing to pay \$6,000 a year for a nursemaid or day care center to take care of their children. If the expenses cannot be deducted, their taxable income will rise by \$15,000, but after defraying their child care expenses, they will net only \$9,000 more in cash—in fact, less than that when they take into account the secondary breadwinner's social security taxes, increased cost of lunches and clothing, and reduced opportunities to shop for bargains—not to mention the additional income tax liability which will be incurred by adding this second income to the first and thereby subjecting it to a higher marginal rate.

When Congress decided to intervene in this area in 1954, it was faced with a choice of alternatives. It could have reduced or eliminated the disparity just described by taxing one-job married couples on the value of the household services performed by the stay-at-home spouse. Had this route been chosen, our couple would have to report \$21,000 of income if only one spouse worked (\$15,000 of wage income and \$6,000 of imputed income from domestic services in caring for the children). Since their income would rise to \$30,000 if both were employed, the difference in taxable income between one job and two would be \$9,000, which is the amount of additional cash generated by the second job after paying the nursemaid or day care center.

Although the theory of this solution is widely approved by economists, virtually no one thinks that it is feasible. It would not only entail controversial and abrasive valuations by the IRS of unpaid domestic services, but it would also require taxes to be paid for engaging in activities that, however valuable, do not produce any cash. It is not surprising, therefore, that Congress chose in 1954 to reduce the tax bias against dual employment by allowing two-job married couples to deduct their child care expenses, rather than by taxing one-job married couples on the imputed value of their unpaid domestic services. In recommending this approach,

the legislative committees said that a two-job married couple's child care expenses are "comparable to an employee's business expenses."<sup>17</sup> I dare say that most informed citizens would agree, not merely those who derive a personal benefit from the statutory allowance.

The 1954 legislation, however, did not grant full-fledged business expense treatment to child care expenses. Even today, despite a number of liberalizing amendments in the intervening years, their status is inferior to that of ordinary business expenses. Business expenses are deductible regardless of amount, subject only to a vague requirement of reasonableness and, in the case of travel and entertainment expenses, to a disallowance of lavish and extravagant amounts. By contrast, there is a dollar limit on the amount of child care expenses that can be taken into account no matter how much the taxpayer may actually spend. Moreover, when the deduction enacted in 1954 was converted into a credit in 1976, Congress imposed a percentage limit on the tax benefit to be derived from the expenses that are taken into account. Without going into the arithmetic, I will simply say that for some low income taxpayers the tax benefit from child care expenses is greater than the benefit from an equal amount of business expenses; that for most middle- and upper-income taxpayers, they are less beneficial than business expenses; and that the bias against child care expenses increases as the taxpayers move up the income ladder. Thus, when top bracket taxpayers incur \$4,000 of travel and entertainment expenses in a business or profession, the deduction reduces the taxpayer's federal income tax liability by \$2,800; but the same amount of qualified child care expenses will generate only \$800 of tax savings.

Why this bias against child care expenses, relative to the status of ordinary business expenses? Having said that child care expenses "are comparable to business expenses" and constitute "a cost of earning income,"<sup>18</sup> why has Congress not given them full business expense status?

The answer, I presume, lies in the fact that child care expenses, even if incurred solely to enable both parents to work, inevitably relieve them of the obligation of caring for their children in person. For some working parents, of course, this may be an unpleasant feature of dual employment; they may yearn to spend more time with their children. Others, however, may welcome this respite; after all, many parents hire domestic servants to care for their children or put them in day care centers even though they are not compelled to do so by business or occupational exigencies.

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17. S. REP. NO. 1622, 83d Cong., 2d Sess. 36 (1954). See also *Senate Comm. on Finance, Revenue Act of 1971*, S. REP. NO. 92-437, 92d Cong., 2d Sess., reprinted in [1971] U.S. CODE CONG. & AD. NEWS 1918, 1966 ("Domestic help expenses can to some extent be likened to an employee business expense."); *Senate Comm. on Finance, Tax Reform Act of 1976*, S. REP. NO. 94-938, 94th Cong., 2d Sess. 132, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3439, 3565 (Child care expenses "should be viewed as a cost of earning income.").

18. See note 17 *supra*.

But child care expenses are not the only business-induced expenditures with a personal component that is viewed with pleasure by some taxpayers and revulsion by others. Travel and entertainment expenses have the same chameleon-like features; some taxpayers welcome the opportunity to travel on business and may even gravitate to occupations that require frequent travel. For other taxpayers, however, a business trip may be unrelieved tedium. Since it is not feasible to separate the sheep from the goats, Congress has chosen to allow all taxpayers to deduct their business-induced travel and entertainment expenditures, whether they enjoy the activity or not, subject to certain restrictions to reduce abuse.

In the case of child care expenses, however, Congress has chosen to compromise: taxpayers get a tax savings whether they are pleased or depressed at being relieved of the obligation to care for their children, but the amount of the savings is strictly limited. The bias against child care expenses is greatest in the case of high income taxpayers, perhaps on the tacit assumption that they are more likely to enjoy being relieved of the burden of looking after their children in person than are low income taxpayers. As to the validity of this distinction, I defer to the social psychologists.

In describing the tax allowance for child care expenses, I have been referring to married couples, but they are not, of course, the only taxpayers incurring expenses of this type. Divorced, widowed and other unmarried parents also often have to pay for the care of their children during working hours. Moreover, children are not the only dependents requiring care. Taxpayers who are responsible for elderly parents and other disabled relatives may be unable to work unless they hire domestic servants to care for their dependents.

Congress recognized both of these points in 1954. Although the principal impetus for enacting a tax allowance was the plight of the two-job married couple with young children, the provision was never limited to this group of taxpayers, and the circle of qualifying taxpayers and dependents has been enlarged several times since 1954. But the tax allowance has never been open-ended: expenditures to care for a disabled friend or distant relative, for example, do not qualify.

In many families, children of high school age look after their younger brothers and sisters, particularly between the end of the school day and the time when their parents get home from work. Building on this fact of life, some taxpayers sought to treat weekly allowances paid by them to their older children as deductible child care expenses. Although these amounts, if deducted by the parents, would be includible in the children's gross income as compensation for services, there would ordinarily be no tax liability because the recipient's gross income would be below the taxable floor.

Congress intervened in 1971 to forbid a deduction in this situation, presumably on the theory that the weekly allowance would usually be paid

in any event, whether the older children took care of the younger ones or not. Although this rationale is plausible, the resulting statutory disqualification of payments to certain members of the family means that neighbors can deduct payments to each other's children, but not payments to their own. On the stated ground that "[r]elatives generally provide superior attention," Congress softened this prohibition to some extent in 1976,<sup>19</sup> but it continues to bar most payments to the taxpayer's children.

Throughout this discussion, I have referred to expenses incurred to enable the taxpayer to accept employment outside the home, but the shoe may be on the other foot. Instead of hiring a baby-sitter so that he or she can work, the taxpayer may work in order to hire a baby-sitter. Nothing short of psychoanalysis or a truth serum, if that, can disclose with assurance whether a particular taxpayer's expenses fall in the hire-to-work, or the work-to-hire, category. As an indirect way of disallowing expenses incurred by taxpayers who work primarily or solely to rid themselves of child care responsibilities, current law provides that expenses cannot be taken into account if, and to the extent that, they exceed the taxpayer's earned income; in the case of married couples, the limiting amount is the lesser of their separate earned incomes.

This restriction is evidently based on a tacit assumption that if the taxpayer earns less than the cost of caring for the children, the excess is a personal outlay, not a genuine business expense. But this solution to the perceived problem is, at best, a rough and ready compromise. It is entirely possible that the taxpayer expected in good faith to earn substantially more than the child care expenses, and that this expectation was frustrated by illness, business competition or other extraneous circumstances. The restriction, therefore, is another example of the legislative refusal to treat child care expenses as full-fledged business expenses. A taxpayer who incurs ordinary business expenses in excess of business income can deduct the resulting loss from other income; child care expenses, however, cannot be used to generate a deductible loss in similar circumstances.

A final aspect of the tax allowance for the care of dependents is worthy of note. The allowance is (and has always been) allowed only to taxpayers with children or other qualifying dependents. Yet the cost of caring for dependents is only one category of expenses that are created, or increased, by employment outside the taxpayer's home. Two-job married couples, whether they have children or other dependents or not, have less time to maintain their homes, prepare meals and shop for bargains than do one-job married couples. Unmarried employees who live alone are subject to a similar disability as compared with single persons living on

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19. See S. REP. NO. 94-938, 94th Cong., 2d Sess. 133, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3566; and *compare* I.R.C. § 214(e)(4) (1975) (repealed by Tax Reform Act of 1976, Pub. L. No. 94-455, § 504(b), 90 Stat. 1565) with I.R.C. § 44A(b)(6).

pensions or income from investments. Why not, then, permit employed taxpayers to deduct all expenses that are incurred in order to work, not merely the cost of caring for their children and other qualifying dependents?

A moment's reflection will disclose the answer: such a broad tax allowance could not be administered. Couple A might assert—quite plausibly—that they spend \$1,000 a year more for food because they have no time to patronize supermarkets and must buy their supplies at expensive delicatessens and bakeries close to their offices. Couple B, with equal vigor, might assert that they are so tired at the end of the day that they spend \$3,000 more for restaurant meals than they would if one of them could stay home and cook. Couple C might argue that their dual employment increased their out-of-pocket expenses by \$10,000 because it prevented them from building their own home, raising their own fruits and vegetables and weaving their own clothes.

In point of fact, some taxpayers would undoubtedly prefer to lead a do-it-yourself life, outside the market economy, if they were not deprived of time and energy by the requirements of their jobs. For them, expenditures for food, clothing and shelter are often as clearly caused or increased by their employment as the child care expenses incurred by two-job married couples. But there is no way to separate these claims from those that would be advanced by impostors if Congress expanded the child care allowance to cover all types of household expenses incurred by employees because of their work. For this reason, when Congress wanted to do something to recognize the added living expenses of employed persons, it confined itself to a token earned income credit, applicable on a percentage basis to a limited group of low-income taxpayers, which makes no effort to determine the actual increase in the taxpayer's living expenses attributable to employment.<sup>20</sup>

From 1954 until 1972, the tax allowance for child care expenses distinguished between the costs of caring for children and other qualified dependents and the costs of household services, such as cleaning the house and preparing meals; only the former were deductible. (Whether this legal distinction was in fact enforced is another matter.) In 1972, however, the distinction was abandoned.<sup>21</sup> The result is that taxpayers with children or other qualifying dependents can get a tax allowance for household services even if the cost is unrelated to the children or dependents. Similar expenses incurred by other employed taxpayers are not deductible.

I have reviewed these aspects of section 44A of the Code to illustrate two points:

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20. I.R.C. § 43.

21. Compare I.R.C. § 214(a) (1971) with I.R.C. § 214(a)(2) (1972) (repealed by Tax Reform Act of 1976, Pub. L. No. 94-455, § 504(b), 90 Stat. 1565) and I.R.C. § 44A(c)(2)(A).



(1) Tax allowances almost always serve objectives that can muster wide support among citizens of good will and common sense, even though they derive no personal benefits from them. A corollary of this proposition is that tax reformers make a serious tactical error in thinking and charging that the principal barrier to change is a coalition of narrow vested interests.

(2) In achieving these objectives, it is almost always necessary to compromise among conflicting values, and the resulting statutory details, no matter how complicated, are rarely capricious or absurd. A corollary of this proposition is that simplification will often produce a less equitable compromise. All things considered, a change may be desirable, but it will often be a lesser evil, rather than an unalloyed improvement on the status quo.

I realize, of course, that I have presented these claims to you as broad generalizations, after dissecting only one illustrative tax allowance; so that I am skating—and asking you to skate—on thin ice. For what it is worth, however, I offer you my conviction that substantially the same conclusions would be reached by a similar, provision-by-provision analysis of the entire Code.

I would like to turn now to a very different aspect of our federal income tax system: the fact that we are deplorably ignorant of the actual economic consequences of most of its provisions—especially so-called special tax allowances, such as the exclusion of certain items from gross income, deductions designed to stimulate investment or other activities and credits. Once again, I will illustrate my thesis with only a single example.

As is well known, investors in state and municipal bonds are not taxed on the interest received by them. (When enacted in 1913, the exclusion was thought by some to be compelled by the Constitutional distinction between states and the federal government, but the exclusion has been perpetuated as a device to assist states and their political subdivisions in financing their operations with borrowed funds.) Tax theorists are traditionally hostile to the exclusion, arguing that it creates an unjustified difference in tax liability among taxpayers who are otherwise similarly situated. Indeed, the standard classroom example of a violation of horizontal equity entails a comparison of A and B, both subject to a marginal tax rate of 70%, each of whom realizes an additional \$1,000 of interest income. Because A invests in taxable industrial bonds, he pays a tax of \$700 and is left with \$300; B, being more tax conscious, invests in tax-exempt bonds of equal risk, so his \$1,000 of interest is unscathed by any tax liability.

Students sometimes ask why they should be disturbed by this comparison, since the example implies that A suffers from a self-inflicted wound. He is a fool, they suggest, not a victim; let him follow B's example, and the alleged inequity will vanish. Whatever may be the reason for the persistent failure of some taxpayers to take advantage of tax allowances that are open to them, the instructor usually answers student objections

to his example by asserting that A should not be forced into investments he did not want in order to get on a plane of equality with B.

Instructors sometimes round out this reply with a concession that somewhat undermines the force of the original example: that the interest rate on tax-exempt bonds is lower than the rate on comparable industrial bonds, so that if A switches from taxable to tax-free bonds, his return will be less than \$1,000. On hearing this, alert students of course ask "How much less?" And students wanting to back the instructor into a corner—and what red-blooded American law student doesn't?—will go on to argue that the investor who was getting 10% from industrial bonds will be willing to buy tax-exempt bonds if they pay 3% (or a bit better), since for a taxpayer subject to a marginal rate of 70%, 3% tax-free is the same as 10% taxable. Assuming, therefore, that competitive conditions prevail in the market and that all tax-exempt bonds offered are purchased by top-bracket taxpayers, the interest rate on exempt bonds will be only 3% if industrial bonds of equal risk pay 10%. Thus, if A has \$10,000 to invest, he will get \$1,000 a year if he buys taxable industrial bonds, of which he can keep \$300 after taxes; but, if he switches to tax-exempt bonds, his \$10,000 investment will produce an annual yield of only 3%, or \$300, tax-free.

On these heroic assumptions, the entire benefit of the tax exemption will pass through to the borrowers: cities and states will be able to borrow at 3%, while taxable borrowers will have to pay 10% to sell bonds of equal risk. Investors, on the other hand, will derive no benefit from the tax exemption, since their economic position will be the same whether they buy tax-free bonds and keep the 3% yield, or buy taxable bonds, get 10%, pay their taxes and keep 3%. Though they claim the exemption, they are only conduits through which the benefit passes to the borrowers.

If we turn now to real life, we find that the interest rate on tax-exempt bonds is not 3% when comparable industrials pay 10%; it is more like 5% or 6%. In the view of most economists, this relationship reflects the fact that cities and states have had in recent years a virtually insatiable appetite for funds, leading them to flood the market with tax-exempt bonds. But this process is inherently self-destructive; if the supply of bonds is so great that they are not all purchased by top-bracket taxpayers, the borrowers must appeal to taxpayers in ever lower tax brackets, and this requires higher rates of interest than 3%. For taxpayers subject to a 40% marginal tax rate, for example, industrial bonds paying 10% produce a net return after taxes of 6%; so they will not buy tax-exempt bonds unless they also offer a 6% return. Hence, to bring these taxpayers into the tax-exempt bond market, the interest rate will have to be boosted from 3%—enough to attract the top-bracket investors—to 6%—the rate which will attract lawyers, dentists and other plebeian investors.

Once this happens, however, the top-bracket taxpayers, who would have been content with 3%, get a windfall, since all tax-exempt bonds, not merely the ones offered to lawyers and doctors, will be paying 6%. In effect, the tax benefit trickles up. The lawyers and dentists (subject to a 40% tax rate in my illustration) will get no benefit from the exemption, since for them there is no differentiation between 10% taxable and 6% exempt. But taxpayers subject to higher marginal tax rates—50%, 60% and, especially, 70%—will derive benefits, and the amount of the benefit will rise with income. But even the top-bracket taxpayers will not get the full benefit of the exclusion. It will be shared by them with cities and states, who will be able to borrow at 6% when comparable industrial bonds must pay 10%.

Having sketched these two types of responses to tax allowances—one involving competition that transfers the entire tax benefit from the private lenders to the cities and states who issue the exempt bonds; the second involving a partial transfer of the exemption through competition, so that it is shared by the taxpayers with the cities and states—I now want to describe a third situation, in which the entire benefit of the tax allowance is retained by the taxpayer.

An example of this third situation is the extra personal exemption of \$750 per year to which blind taxpayers are currently entitled. It is conceivable that a minuscule part of this exemption is competed away; since blind taxpayers must prove that they meet the statutory requirements, the resulting demand for expert testimony may increase slightly the fees charged by ophthalmologists. With this trivial exception—which I offer only to prove that I have considered this matter thoroughly—the tax benefit of the extra exemption is not only *claimed*, but is also *retained* by blind taxpayers.

Unfortunately, we know precious little about the actual impact of most tax allowances. We can only guess at whether they are retained in full by the taxpayer, competed away in full or shared. And if the benefit is shared, we know almost nothing about the proportion retained by the taxpayer. Very few allowances have been systematically examined by econometricians; the few studies that there are have not yielded unambiguous and generally accepted results.

Given this melancholy state of our knowledge, it is not surprising that journalists and politicians assume that tax allowances inure wholly to the benefit of the taxpayer claiming the allowance. Tax theorists know better, but they often employ the same assumption in their public utterances. As a tactic in the political arena, this is understandable. Academicians like to appear decisive, not vacillating. Nevertheless, ignorance is ignorance, whether it is acknowledged or not, and that is, alas, our intellectual state as to the economic consequences of most tax allowances. Among other things, this means that the federal income tax system may not have the effects that are often attributed to it, and that modifications may not produce the changes that their proponents seek to achieve.

## C. WHAT NEXT?

In discussing the future, I want to disclaim, firmly and without qualification, any prophetic expertise. Having done so, I can freely offer you, also firmly and without qualification, my predictions.

I think, to be blunt, that we will see a series of so-called tax reform bills and laws, which will not significantly change the face of the Internal Revenue Code. In the last decade, we have had three such statutes: the Tax Reform Act of 1969, the Tax Reform Act of 1976 and the Tax Reduction and Simplification Act of 1977. Except for their pretentious titles, these recent laws were not much different from many other statutes enacted by Congress over the years to amend the Internal Revenue Code of 1954 or its predecessor, the 1939 Code.

In saying this, I do not want to denigrate the importance of the 1969, 1976 or 1977 Acts. Each made some significant changes in the law, simplifying some areas and complicating others. The 1969 Act cut back on percentage depletion, previously regarded as a sacred cow, reduced the tax advantages of long-term capital gains, added the minimum tax on tax preferences, and imposed severe restrictions on private foundations. The 1976 Act repealed the long-standing rules under which inherited property acquired a new basis equal to its value at the date of the decedent's death and substituted complex carryover basis rules, limited many tax shelter opportunities, and imposed restrictions on deductions for vacation homes and offices in the taxpayer's residence. The 1977 Act converted the optional standard deduction into the new zero bracket amount and made related changes that are expected to reduce by 7.3 million the number of returns with itemized personal deductions.

All of these provisions, which constitute only a few of the changes made by these three acts, are of great importance; but, when all is said and done, they do not begin to approach the massive simplification that many tax theorists have in mind when they advocate tax reform. I say this even though the Tax Reform Act of 1969 has been called "the most comprehensive substantive reform of the federal income tax law since its inception in 1913."<sup>22</sup> This characterization is probably valid when the 1969 Act is compared with what went before, but it is an assemblage of minor (although complicated) details when compared with the vision of comprehensive tax reform that is usually conjured up by tax reformers. In the interest of realism, it should also be said that the 1969 Act's status as the most comprehensive reform since 1913 may be equally valid when we look back at it ten years from now.

Congress, in my view, will continue to lurch from side to side as it has in the past. To give more content to this prediction, I would like to discuss some of the tactics of reform that have been employed in the past

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22. 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, *FEDERAL INCOME TAXATION: CASES AND MATERIALS* 25 (1972).

and that we can expect to see in the future. In this analysis, I will be concerned only with devices to prune or eliminate *existing* exclusions, deductions, credits and other tax allowances. I see no reason to believe, however, that Congress will not simultaneously add new allowances to the Code—the educational tuition tax credit now being considered is an example—which will in turn become candidates for expansion and contraction from time to time. Let me turn, then, to the major categories of tax reform devices.

(1) *Repeal.* The most drastic legislative action that Congress can take is, of course, repeal of a particular tax provision. This relatively rare fate befell the 4% credit allowed by the 1954 Code for dividends received by individuals, which was repealed by the Revenue Act of 1964.<sup>23</sup> The repeal was accompanied, as is not uncommon, by a sweetener, in the form of an increase in the dividend exclusion from \$50 to \$100.

The 1964 repeal of the dividends-received credit illustrates another fact of life: eliminating symptoms does not cure disease, whether the disease is of organic or psychosomatic origin. When enacting the 4% dividends-received credit in 1954, Congress said that it was addressing the problem of the double taxation of corporate earnings. Without commenting on the validity of the underlying complaint, I simply point out that the 1964 repeal of the credit did not terminate the debate. As many people know, it flared up again last year; and, although legislation to integrate the corporate and personal income taxes does not seem imminent, the area certainly will not remain quiescent in perpetuity.

(2) *Phase-in and grandfather clauses.* Another tactic that is often employed when tax allowances are repealed is a gradual phase-in of the new law or a grandfather clause preserving the old law for taxpayers who may have relied on it. When Congress repealed the unlimited charitable deduction in 1969, for example, the change took effect in a series of steps over a five-year period. A similar policy of gradualism was employed in 1975, when the percentage depletion rate for oil and gas was reduced from 22% to 15% in stages over a ten-year period. Grandfather clauses are also not unusual. When Congress in 1976 repealed the tax exemption of disability pensions received by members of the armed forces, for example, it made the repeal inapplicable to anyone who was a member of the armed forces on September 24, 1975, or who was then under a binding commitment to join.

Phase-in and grandfather clauses are a method of purchasing political acquiescence in tax reform measures, but they are also advocated by some tax theorists as devices to avoid imposing a capital levy on taxpayers who purchased tax-sheltered property (or entered into other commitments) at

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23. Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19. The "deadwood" portion (Title XIX) of the Tax Reform Act of 1976 repealed a great many obsolete statutory provisions, but this cleanup operation was concerned with debris that had accumulated over decades, not with currently important tax allowances.

a price reflecting an expectation that the tax allowance would continue.<sup>24</sup> A tax-exempt bond with an interest rate of 6%, for example, would obviously not sell for \$1,000 were it not for the tax exemption, if comparable taxable industrial bonds carry a 10% rate of return. Proposals to repeal the exemption, therefore, are usually limited to future issues.

Concessions of this type can be viewed as corollaries to the point I made in the previous section, *i.e.*, that some tax allowances are competed away so that the nominal taxpayer is only a channel through whom the tax benefit passes, in whole or in part, to other persons. In these circumstances, the most equitable way to repeal the allowance might be to allocate the future cost between the taxpayers and the other beneficiaries of the allowance in proportion to their enjoyment of its benefits. As I pointed out before, however, we know little about the real-life division of benefits—some tax allowances may be competed away in their entirety; others are shared in unknown proportions between taxpayers and other persons; and still other allowances inure wholly to the benefit of the taxpayer who claims them.

Moreover, the extent to which the tax allowance is capitalized or otherwise reflected in market transactions between the taxpayer and other persons depends on their expectations about the allowance's permanence. If taxpayers believed that Congress was on the verge of repealing the tax exemption for *existing* state and municipal bonds, new issues would have to carry an interest rate commensurate with the death sentence. Taxpayers who had little faith in continued tax exemption would pay correspondingly little for transitory immunity. But just as we know little about the extent to which tax benefits are shared among the participants in a tax-sheltered business or financial transaction, so we know little about how much is paid for expectations in this area. Tax allowances are sometimes portrayed as immortal, but do taxpayers make this assumption in real life? If not—if they gamble against repeal—is there any reason to protect them with grandfather clauses?

(3) *Flanking devices.* A third tax reform tactic is to leave a tax allowance in force without direct change, but to sap its vitality by a flanking movement. This tactic has been used repeatedly to undermine the itemized personal deductions (medical expenses, charitable contributions, casualty losses, interest, taxes, etc.); although so far confined to this area, it could be applied elsewhere as well. I am referring, of course, to the optional standard deduction, which was converted in 1977, with little substantive change, into the zero bracket amount. I will use the provision's old label, because it is more familiar and also more descriptive of its function.

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24. See Feldstein, *Compensation in Tax Reform*, 29 NAT'L TAX J. 123 (1976); Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977).

As you know, taxpayers are offered a choice between itemizing their personal deductions (along with a few business deductions) and taking the standard deduction. This option was enacted in 1944 to simplify the preparation and audit of personal tax returns. Taxpayers who know that they will elect the standard deduction do not have to keep records of their personal deductions, and their tax returns, like their desks, are free of clutter. When enacted, the optional standard deduction was subject to a ceiling of \$500 and was elected by about 82% of individual taxpayers. But as time passed, incomes and deductible personal expenses rose dramatically, and more and more taxpayers found it profitable to itemize rather than to take the standard deduction. Congress repeatedly raised the standard deduction to recapture its lost customers, but they would then drift away again and become itemizers, as incomes and deductible personal expenses increased once more.

The most recent—but surely not the last—episode in this cyclical pattern occurred in 1977, when the standard deduction was increased in amount and converted into the zero bracket amount with the objective of increasing its patronage by 7.3 million taxpayers. The resulting simplification of their returns greatly reduces the audit burden for the IRS, but there are offsetting costs that should be taken into account in assessing the merits of this method of sidestepping tax allowances that Congress does not wish to attack directly.

First, the direct revenue cost is very great, since the increased standard deduction is available not only to taxpayers who would otherwise have itemized their personal deductions, but also to the much larger group who would not have itemized in any event. The 1977 change, for example, is expected to increase the percentage of taxpayers choosing the standard deduction from 69% to 77%.<sup>25</sup> Thus, almost 90% (69/77) of the taxpayers who get the benefit of the increase would have chosen the standard deduction anyway. In this respect, therefore, an increase in the standard deduction resembles an increase in the interest rate on tax-exempt bonds, which produces the “trickle up” phenomenon described in the previous section, except that most of the benefits of an increased standard deduction trickle down, since the non-itemizers are mostly low-income taxpayers.

A second consequence of sidestepping the personal deductions by increasing the standard deduction is to frustrate the policy objectives of the personal deductions. To illustrate this point, assume that two married couples have identical amounts of income and are similarly situated in all other respects, except that one family incurs \$3,200 of deductible medical expenses or casualty losses. Were it not for the standard deduction, the family with the medical expenses and casualty losses would have a lower tax liability, reflecting what Congress—and no doubt much of the public—regards as a reduced ability to pay. But a standard deduction of \$3,200

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25. See S. REP. NO. 94-938, 94th Cong., 2d Sess. 118, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3553.

is available to the other family, thus eliminating any tax difference between the two families.<sup>26</sup> Every time Congress increases the standard deduction, it necessarily blurs the distinction between taxpayers who incur deductible expenses and those who do not.

Increases in the standard deduction also undermine the incentive effect of tax allowances that are designed to alter taxpayer behavior. This effect can be illustrated by assuming that the family just described, with \$3,200 of deductible medical expenses and casualty losses, is solicited in December to make a contribution to a charitable organization. If they donate \$300 to charity, they will be able to deduct \$3,500. Since the zero bracket amount would be only \$3,200, it is advantageous for them to itemize. Thus, the charitable contribution produces a tax benefit, and this serves as an incentive to make the contribution. If Congress increases the standard deduction to \$3,500, however, and all other circumstances remain the same, a charitable contribution of \$300 will produce no tax benefit, and they will be less likely to make it.

These effects of the standard deduction suggest that increasing efforts will be made to shield some itemized deductions from nullification by permitting them to be taken in addition to the standard deduction. This change has already been effected for alimony, and charitable organizations are lobbying for a credit or other allowance for charitable contributions that will be independent of the standard deduction. The standard deduction, I suggested earlier, is a method of outflanking the itemized deductions. Now we are seeing an effort to restore some of the itemized deductions by outflanking the standard deduction.

Finally, it should be noted that increases in the standard deduction eliminate the need to keep records of personal deductions only for taxpayers who are absolutely sure that their itemized deductions will not exceed the standard deduction. Many taxpayers, however, do not know until after the end of the taxable year whether itemizing will be preferable to the optional standard deduction, so they must keep records or lose out.

(4) *Minimum tax on tax preferences.* Another tax reform tactic is the minimum tax on tax preferences, enacted in 1969 and materially revised in 1976. Briefly summarized, the minimum tax is imposed on taxpayers who receive a substantial amount of certain tax preference items, such as capital gains, percentage depletion, stock options, accelerated depreciation and certain personal deductions. The announced purpose is to insure that at least a minimum amount of tax is paid on tax preference items, especially by high-income taxpayers who otherwise would pay little or no regular income tax.

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26. The standard deduction or zero bracket amount could be rationalized as a device to disallow a "normal" amount of personal items, on the theory that medical expenses, casualty losses, etc., affect a family's ability to pay only if, in the aggregate, they exceed the applicable standard deduction or zero bracket amount. But this is not the announced function of either provision.



Although the minimum tax may in fact have been enacted primarily for its public relations or cosmetic effect, it is worth serious attention. As applied to tax preference items that were enacted as investment or business incentives, the minimum tax is a curious device. If Congress wants to encourage the construction of buildings, pollution control facilities and other tax-favored investments, why boggle if new taxpayers move into these areas in full force? Why penalize them for getting more than ankle-deep into the very waters that Congress is urging taxpayers to enter?

The answer, presumably, is that taxpayers who concentrate on tax-favored investments do not pay as much in taxes as those who avoid those areas or who patronize them sparingly. By tending to restrict the amount invested by any one high-income taxpayer in tax-preferred activities, the minimum tax is expected to increase the effective tax rate on these taxpayers. If other high-income taxpayers take up the slack by investments that are small enough to qualify for the basic tax allowance without incurring the penalty of a minimum tax,<sup>27</sup> however, the aggregate cost of the basic allowance to the Treasury may remain the same. Viewed as a method of spreading a given amount of tax benefits among a larger circle of high-income taxpayers, the minimum tax serves a cosmetic role in an area where appearances can be more important than reality. Not much more can be said in its favor.

It is also possible, however, that the minimum tax will cause the only high-income taxpayers who are attracted by the tax-preferred activities to curtail their participation, and that other high-income taxpayers will *not* leap into the breach. In this event, the activity that Congress is seeking to encourage will decline in volume, unless the rate of return offered by these activities rises to the point where they become attractive to lower-income taxpayers. If the latter condition prevails, the increased rate of return will inure, gratuitously, to the benefit of any high-income taxpayers who continue to invest in the same tax-preferred activity. The result would be a trickle-up phenomenon of the type which occurs when the interest rate on tax-exempt bonds increases. This is hardly compatible with the equity objective that prompted enactment of the minimum tax. So far as I can recall, however, no tax economist has addressed this possibility that the actual effect of the minimum tax is the opposite of its intended effect.

(5) *Channelization*. Another tax reform tactic that has been employed on several occasions in recent years, and that may be on the rise, is a channelization of income and deductions, designed primarily to prevent taxpayers from deducting expenses incurred in one activity from income

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27. The minimum tax comes into force only if, and to the extent that, the taxpayer's aggregate preference income (as defined) exceeds either \$10,000 or one-half of the taxpayer's regular tax liability, whichever is greater. See I.R.C. § 56(a) (1). [Note: This does not take account of the proposed 1978 changes in the minimum tax; but they do not undermine the criticism offered in the text.]

derived from an unrelated profession or business. The details of these reform measures vary, but the common thread is the preservation of particular tax allowances for full-time farmers, ranchers and other taxpayers who participate directly in a tax-favored business or occupation, while denying or restricting use of the same allowance by passive investors and other part-timers, such as lawyers, orthodontists and accountants. The emotional tone underlying these statutory distinctions is conveyed by references to the deserving group as "genuine" or "dirt" farmers—no matter how extensive or lucrative their agricultural operations may be. The restricted taxpayers, by contrast, are described contemptuously as "outsiders" or "white collar cowboys."

I have grave doubts about the wisdom of this distinction from a policy point of view. Much can be said for permitting funds to flow wherever the investor thinks they will earn the greatest after-tax return. And if Congress determines that farming or any other activity should enjoy a tax allowance, I see no reason to reserve the benefits for those already in the business, as against persons who wish to commit their funds to it. The phrase "white collar cowboy" is catchy, but from an economic point of view, does it make any sense to treat investments made by one taxpayer differently from those made by another? The distinction, I might add, has led Congress to create what might be called honorary, or birthright, dirt farmers. By virtue of section 464(e)(2), the special status given to full-time farmers also shelters the farmer's uncles, aunts and cousins, even if they are city slickers who don't know the difference between oats and barley.

Whatever the defects of channelization devices may be, however, I expect their use to increase. They permit tax allowances to be preserved for taxpayers who have become accustomed to them, while placating popular demands that "something be done." There is always a market for superficial remedies, and they are as American as the patent medicine man.

As applied to the Internal Revenue Code, however, these nostrums produce complexity, not simplification. Our existing tax system is, by and large, a global system in the sense that all income is thrown into one pot, all deductions are then taken, and the residue is taxable income. Capital gains and losses constitute the principal exceptions to the global concept; they must be segregated for separate treatment, creating a host of definitional problems. In contrast to our global system (which can rightly be regarded as a major legacy from the founding fathers), the British used to have a "schedular" income tax, involving separate computations of income from the taxpayer's principal occupation or profession, income from investments, income from farming and income from a number of other activities, with a separate tax for each type of income. If channelization becomes more frequent as a tax reform tactic, the global concept will recede into the background, and we will get closer to the far more complicated schedular system.

To conclude this lecture series, I wish to say a few words about the expenditure or consumption tax, which, as I said earlier, has been suggested as a substitute for the federal income tax.<sup>28</sup> The subject obviously deserves extended discussion and, in fact, I had originally intended to use these lectures as the occasion for an intensive analysis of its main features. Having abandoned that plan, perhaps it would be wise to remain silent, for any brief comment runs the risk of superficiality.

Recognizing the risk, I still want to note that expenditure tax proposals have so far been presented and discussed largely at a high level of abstraction. A few commentators have tried to put flesh on the skeleton, but they have only begun the process.<sup>29</sup> In this respect, the expenditure tax resembles the federal personal income tax as of 1913, and as I pointed out in my first lecture, most of the knotty problems that plague us today in that area were not foreseen by the founding fathers.<sup>30</sup>

I will content myself here with two examples of problems in the expenditure tax area paralleling problems that the founding fathers of the income tax failed to address. Assuming a graduated rate schedule, it will make a great difference whether expenditures are charged to parents or to their children. Unless elaborate rules are adopted to prevent the practice, wealthy families will be able to shift tax liability for ordinary living expenses to their children by transferring property to them, directly or in trust, to finance the expenditures. I can envision counter-measures, to be sure, but they would add intricacies to a system that, so long as it remains an ideal, can be described as simple and straightforward, as compared with the existing income tax.

In the same vein, I call attention to the fact that an expenditure tax, like its income tax counterpart, would have to separate taxable personal expenditures from nontaxable business expenses. The three-martini lunch, travel and entertainment expenses and child care expenses, for example, would be as troublesome for an expenditure tax as they are for the income tax.

I could add to this list of expenditure tax problems, but this is not the time or place for an extended disquisition. My purpose is not to indulge in a final judgment on the expenditure tax concept, but to suggest that its advocates should not offer a money-back guarantee until they can unveil a far more detailed model than has been exhibited so far. Contemplation of the gap between the income tax envisioned by the founding fathers and today's law (whether it is a national disgrace or not) should provide a sobering comparison.

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28. See note 8 *supra* and accompanying text.

29. *Id.*

30. See section A *supra*.

